

**MEMORANDUM**

To: Members of the Investment Committee
California Public Employees' Retirement System

Date: December 12, 2011


From: Pension Consulting Alliance, Inc. (PCA)

RE: Real Estate Performance through September 30, 2011

PCA received and reviewed Wilshire's Third Quarter 2011 Executive Summary of CalPERS' Investment Performance as it relates to the Real Estate Portfolio. The following items should be considered in your assessment of Real Estate's performance:

- In an illiquid asset class populated with multi-year partnerships, longer term results are more significant than those of a shorter duration.
- Over the long-term, the real estate program has had poor results, with returns of -19.4%, -12.5% and 1.9% during the trailing three-, five- and ten-year periods, respectively.
- As previously articulated, the performance of the real estate portfolio has been hindered by three primary factors: (i) the vintage-year concentration during the 2005 to 2007 period; (ii) the high exposure to non-stabilized properties; and (iii) high amounts of leverage employed at the peak of the cycle. These final two factors have exacerbated the recent underperformance to the benchmark, as non-stabilized assets provide less income to insulate valuation declines, and increased leverage magnifies returns in upward and downward market cycles.
- Recent performance has been better. The total Real Estate Portfolio produced a 2.6% return during the quarter and a 14.1% return during the trailing year, compared to the Policy Benchmark returns of 2.7% and 16.9%, respectively.
- The Public REITs, which represent approximately 6% of the market value of the Real Estate Portfolio, reported a one-year return of -6.9%, which matched the REIT benchmark, the FTSE EPRA NAREIT index.
- The Core Portfolio had strong performance over the trailing year with a return of 29.9%, compared to the benchmark return of 16.7%. The Core Portfolio was reappraised as of March 31, 2011 and had significant appreciation, particularly in the Apartment and Retail programs. The March 31, 2011 appraisals captured the impact of cap rate compression across US real estate despite only spotty and moderate improvement in fundamentals.

- The Value-Added portfolio had strong returns for the most recent quarter with a 28.4% return. An appraisal was conducted on the CalEast Solstice holding in the Value-Added portfolio during the second quarter which resulted in a significant write up in value.
- The Opportunistic Portfolio returned 3.4% during the current quarter, which lagged its benchmark of 4.9%. During the longer-term, the Opportunistic portfolio has had poor results with -23.2%, -19.4% and -3.4% returns during the trailing three-, five- and ten-year periods.
- The market value of the Real Estate Portfolio as of September 30, 2011 was \$19.1 billion, which represents an increase of \$3.9 billion, or 26%, from last year (September 30, 2010). The overall increase in value in the Real Estate Portfolio is attributable primarily to appreciation and new equity funded for deleveraging assets.
- As of September 30, 2011, the real estate asset class represented 8.7% of the total CalPERS portfolio, above the 8.0% interim target allocation approved on August 15, 2011 by the Investment Committee, but below the interim target allocation for calendar 2012 of 9.0%, and below the long-term target allocation of 10.0%.
- CalPERS also had approximately \$7 billion of unfunded real estate commitments as of September 30, 2011. The bulk of these commitments are to commingled funds whose general partners seek opportunistic investments. To the extent that the distressed segments of the commercial real estate markets become priced more attractively, it can be expected that CalPERS will participate in attractive acquisitions of turnaround properties by funding these commitments in 2012-13.
- The real estate portfolio is in compliance with all debt-related policy metrics. The Loan-To-Value (LTV) for the total portfolio is 47.0%, compared to a 50% limit, and the Core portfolio LTV is 42.4%, compared to a 45% limit. Additionally, recourse debt totals \$1.7 billion, compared to the \$1.9 billion afforded by the policy limit. Over the past 12 months, the overall LTV has fallen by nearly 10% and the recourse debt amount has fallen by \$938 million.
- At the February 2011 Investment Committee meeting, the proposed Real Estate Strategic Plan was approved. This plan provides for the implementation of the revised role of real estate as described in the recent asset allocation study. This role is primarily to provide (i) reliable current income and (ii) diversification from public and private equity return characteristics. Therefore, the portfolio will shift in emphasis over time towards strategic, stabilized, domestic core assets held for a longer term, and away from more tactical, opportunistic, appreciation-oriented investments held for a shorter term.
- CalPERS Staff has been working on setting up new partnership agreements with strategic operating partners in the Base and Domestic Tactical Programs. An additional



partnership in the International Tactical program is also underway. The properties held in these new partnerships would be part of the Strategic portfolio going forward.

- In general, the global commercial real estate markets continue to display weak fundamentals insofar as occupancy demand and increases in net rental rates. This weakness is partially mitigated by below average new construction levels and historically low base rates for mortgage loans. Increases in value currently can be attributed primarily to (i) pent up demand for core property and (ii) relatively attractive current returns from completed properties compared to other available income-oriented investments. Until employment increases, and uncertainty about economic trends is reduced, it is unlikely to expect significant increases in rent and occupancy (other than in US rental apartments, whose fundamentals continue to stay strong).

We are available to take any questions of the Investment Committee.

Respectfully,



David Glickman

Managing Director